

SUMMARY ANALYSIS OF AMENDED BILL

Author: Migden Analyst: Gail Hall Bill Number: SB 663
 Related Bills: See Prior Analysis Telephone: 845-6111 Amended Dates: February 16 & March 13, 2006
 Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Clarify Coordination Of U.S.-Source Income & Subpart F Water's-Edge Partial Inclusion

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

☒ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENTS CONCERNS stated in the previous analysis of bill as introduced/amended _____.

FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

☒ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED MAY 17, 2005 STILL APPLIES.

☒ OTHER – See comments below.

SUMMARY

This bill would clarify specific provisions of the Corporation Tax Law relating to water's-edge taxpayers.

SUMMARY OF AMENDMENTS

The March 13, 2006, amendments revised the bill as follows:

- Changed the general operative date to taxable years beginning on or after January 1, 2006,
- Added language specifying that the provisions added by this bill would not apply to a current water's-edge taxpayer for a taxable year that is within the seven-year period during which the taxpayer may not terminate that election without consent of the department,
- Created special rules for water's-edge original and amended returns filed on or before January 1, 2006, and
- Revised the no inference language.

Board Position:

☒ S _____ NA _____ NP
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 _____ N _____ OUA ☒ PENDING

Legislative Director

Date

Brian Putler

3/20/06

The February 16, 2006, amendments revised the bill as follows:

- Changed the general operative date to taxable years beginning on or after January 1, 2007,
- Expanded the language to specify which taxable years a water's-edge taxpayer would continue to follow pre-existing law, and
- Resolved the implementation consideration discussed in the analysis of the bill as amended May 17, 2005, by adding a repeal date of January 1, 2014, to pre-existing law.

Except for the discussion in this analysis, the remainder of the department's analysis of the bill as amended May 17, 2005, still applies.

ANALYSIS

The following supplements the Current State Law discussion in the analysis of the bill as introduced February 22, 2005.

Current State Law

For taxable years beginning on or after January 1, 2003, the manner of making a water's-edge election substantially changed. The new law replaced the water's-edge contract with a statutory election that continues in effect for a minimum of 84 months (seven years).

A water's-edge election must be for an initial term of 84 months and remains in effect thereafter, year to year, until terminated by the taxpayer. If a taxpayer terminates its water's-edge election, it is required to file on a worldwide basis for at least 84 months before making another water's-edge election. Corporations that made a valid election for taxable years beginning before January 1, 2003, will continue to file on a water's-edge basis, will be deemed to have elected under the new election law, and will keep their original water's-edge election commencement date that is used to calculate the 84 month term.

EFFECTIVE/OPERATIVE DATE

The provisions added by this bill would specifically apply to taxpayers making a water's-edge election on or after January 1, 2006; it would also apply to those taxpayers that made an election before January 1, 2006, where that water's-edge election is in effect, but not until the expiration of the seven-year period during which a taxpayer may not terminate that election without the consent of the department. In addition, the bill states the Legislature's intent that no inference be drawn from the provisions added by the bill with respect to pre-existing law for original or amended returns filed after January 1, 2006, as to whether a taxpayer properly excluded the income of its Controlled Foreign Corporation (CFC) with subpart F income because the CFC qualified or was doing business in the state or reported the U.S. source income.

THIS BILL

This bill would provide the following:

1. Clarify that a CFC with subpart F income that is a California taxpayer cannot exclude its income from a water's-edge return;
2. Clarify that a CFC with subpart F income that also has U.S.-source income cannot exclude its income from a water's-edge return and only include its U.S.-source income;
3. Coordinate existing laws so that the U.S.-source income rules and the CFC with subpart F income rules would operate simultaneously and apply consistently to corporations regardless of whether they are California taxpayers; and
4. Require Franchise Tax Board (FTB) to issue regulations to resolve problems relating to potential double taxation of U.S.-source income and the income of a CFC with subpart F income.

This bill would repeal pre-existing law on January 1, 2014, because no water's-edge taxpayer would be required to follow pre-existing law after tax year 2013.

The bill would provide that for original and amended water's-edge returns filed on or before January 1, 2006, if a taxpayer had taken the position that a CFC with subpart F income may exclude its income from the water's-edge return because the CFC qualified or was doing business in the state or because it had U. S.-source income, the taxpayer's position shall be deemed to be in compliance with the pre-existing water's-edge rules¹.

POSITION

On December 2, 2003, the Franchise Tax Board voted 2-0, with the representative from the Department of Finance abstaining, to sponsor provisions of this bill that clarify existing law. The three member Board has not had an opportunity to consider the amendments to the bill that added various effective date provisions.

¹ Revenue and Taxation Code Section 25110.

ECONOMIC IMPACT

Revenue Estimate

Based on limited tax return data, this bill would result in the following revenue effects.

Estimated Revenue Impact of SB 663 As Amended February 16 and March 13, 2006 [\$ In Millions]			
	2006-07	2007-08	2008-09
Returns Filed Before 1/1/06	-\$1	/a	/a
Returns Not Filed Before 1/1/06 and Before New Statute Applies /b	---	---	---
New Statute Applies to Elections After 1/1/06 /c	---	---	---

/a: minor loss of less than \$500,000. This bill would reduce payment of audit assessments. Budget rules require payments to be accrued back one fiscal year from date of payment.

/b: Negligible loss of less than \$250,000 occurs in a future year beyond the three presented here.

/c: This bill eliminates any risk of taxpayer's position being sustained in court. The potential revenue loss associated with this risk is uncertain but could reach \$50 million annually in future years after 2008-09.

Revenue Discussion

FTB interprets present law as requiring a water's-edge taxpayer to include income of a CFC with subpart F income, regardless of whether the CFC is qualified or doing business in the state or has U.S.-source income. Some taxpayers assert that existing law allows a water's-edge taxpayer to exclude its CFC's income if that CFC qualifies or does business in the state. To date, relatively few taxpayers have asserted this position. The total revenue at risk is uncertain, perhaps a few million annually currently, but could reach \$50 million annually in the near future if the taxpayers' position is sustained. This projection is based on a prior examination by audit staff of corporations with prominent CFCs.

This bill would amend the law to eliminate disputes with respect to this aspect of the law for original or amended returns filed before January 1, 2006, and clarify the law for new or continued water's-edge elections (after the initial seven-year period) for taxable years beginning on or after January 1, 2006. If a taxpayer has not filed an original or amended water's-edge return before January 1, 2006, the taxpayer would still be able to dispute this issue unless the taxpayer's water's-edge election is subject to the new statute.

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